

Message Text

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PAGE 01 BRASIL 08959 312049Z
ACTION EB-08

INFO OCT-01 ARA-10 ISO-00 PER-01 ABF-01 FS-01 AID-05
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FM AMEMBASSY BRASILIA
TO SECSTATE WASHDC 4440
INFO AMCONSUL RIO DE JANEIRO
AMCONSUL SAO PAULO

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EO 11652 NA
TAGS ECON EFIN BR
SUBJECT: MODIFICATION OF RIO COST-OF-LIVING INDEX

REF: BRASILIA 4120

THE FOLLOWING MESSAGE WAS PREPARED BY CONGEN RIO

1. EFFECTIVE IN MARCH THE VARGAS FOUNDATION MODIFIED THE PROCEDURES FOR COMPUTING THE COST-OF-LIVING INDEX FOR RIO. THE IMPACT OF THE CHANGE ON MEASURED INFLATION IS NOT SUBSTANTIAL, E.G., THE NEW PROCEDURES WOULD HAVE PRODUCED A COL INCREASE OF ABOUT 43 PERCENT IN 1976 INSTEAD OF THE 44.9 PERCENT ACTUALLY RECORDED. NONETHELESS, THE MODIFICATION PROVOKED WIDESPREAD CRITICISM SINCE MANY INTERPRETED THE CHANGE AS SIMPLY DESIGNED TO LOWER THE ESTIMATED RATES OF INFLATION.

2. THE NEW PROCEDURE, DESCRIBED IN THE JUNE 1977 ISSUE OF "CONJUNTURA ECONOMICA", EMPLOYS A WEIGHTED 'GEOMETRIC' MEAN OF PRICE RELATIVES FOR ITEMS IN THE FOOD CATEGORY (42 PERCENT OF TOTAL INDEX).

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THE CONVENTIONAL WEIGHTED 'ARITHMETIC' MEAN CONTINUES TO BE USED FOR THE REMAINING CATEGORIES.

3. THE JUSTIFICATION CITED FOR THE CHANGE IS THAT THE GEOMETRIC MEAN GIVES A BETTER "APPROXIMATION OF REALITY" SINCE IT REDUCES THE IMPACT ON THE OVERALL INDEX OF INDIVIDUAL ITEMS WHICH REFLECT ABNORMALLY LARGE PRICE INCREASES--THE ARGUMENT BEING THAT THE

CONSUMER ADJUSTS BY CHOOSING LESS EXPENSIVE SUBSTITUTES.
WHATEVER THE THEORETICAL MERITS OF THIS APPLICATION OF THE
CONCEPT OF ELASTICITY TO DETERMINATION OF THE "MARKET BASKET"
(SEE REFTEL), THE KEY PRACTICAL IMPACT IS TO REDUCE SOMEWHAT THE
MEASURED RATE OF INFLATION SINCE THE GEOMETRIC MEAN WILL ALWAYS
BE LESS THAN THE ARITHMETIC MEAN FOR AN INDEX OF THIS TYPE.

4. THE MAGNITUDE OF THE DIFFERENCE IN RESULTS ACHIEVED BY THE
TWO METHODS WILL DEPEND ON THE SPECIFIC DISTRIBUTION OF PRICE
CHANGES IN THE GIVEN PERIOD, AND A WIDER SPREAD (I.E., A LARGER
NUMBER OF EXTREME CASES) WILL IN GENERAL PRODUCE A GREATER DIVERGENCE

.
IT IS POSSIBLE TO ESTIMATE THE EXPECTED MAGNITUDE OF THE DIFFERENTIAL
BY LOOKING AT A PAST YEAR.

CALCULATIONS FOR 1976 INDICATE THAT THE NEW METHOD WILL PRODUCE
AN ANNUAL DIFFERENTIAL OF APPROXIMATELY 4 PERCENT. GIVEN THE 42
PERCENT WEIGHT OF FOOD, THIS WILL AMOUNT TO A REDUCTION OF 1 1/2
TO 2 PERCENTAGE POINTS IN THE OVERALL COL INDEX. THUS AT THE 1976
RATE OF INCREASE OF 44.9 PERCENT IN THE RIO COST-OF-LIVING, THE
IMPACT OF THE NEW PROCEDURE IS MUCH LESS SUBSTANTIAL THAN THE
CRITICS HAVE SUGGESTED.

CRIMMINS

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